CHAPTER 10

Trade Examples

The main part of intellectual education is not the acquisition of facts but learning how to make facts live.

—Oliver Wendell Holmes

This chapter presents several examples of the trading patterns and ideas in this book applied to real-world market scenarios. Keep in mind that these examples reflect my trading style, which is a pure swing trader's approach that can be summarized as follows:

- Understanding bigger picture money flows between markets. In stocks this might mean understanding the difference in performance between domestic and foreign indexes, and then understanding which sectors offer the most attractive opportunities. This concept can be adapted to other asset classes as well, but the key is to start from a high-level perspective and to work top-down.
- Waiting for precise patterns that indicate the presence of an imbalance. These patterns also give risk points (stop levels) for each position.
- Executing trades to position with the statistical tendency behind that pattern.
- Managing the risk in the trade appropriately, perhaps adjusting the position as the trade develops.
- In almost all cases, I am playing for *one clean swing* in the market.

The last part of that is particularly important: a swing trader's job is to take money out of one swing, usually the next swing, in the market. Swing traders do not enter positions, add to them as they move against the entries, and hope for the best. Swing trading is a style of trading that requires precise entries and active trade management. In many of the examples that follow, you will see that it appears that a lot of money has been left on the table, as I advocate exiting positions when the market would, eventually, have continued to move in the trade's favor. Some traders will find success with an approach that

tries to squeeze every penny out of every move. I have not. I focus on the best and the cleanest trades, and it is important to remember that even apparently profitable moves can be outside of the predictive horizon of the patterns traded. If so, they are simply the result of random noise, and may not represent repeatable opportunities.

The initial risk point and the disciplines surrounding it are perhaps the most important elements of these examples. Every trade, without fail, is entered with a predefined stop-loss point that must be respected without question. This risk point also sets the first profit target, the point at which the profit in the trade equals the initial risk. As a matter of discipline, I take profits on between 25 and 50 percent of the position at this first profit target. There is certainly room for discretion in trade management, and the size of this first exit is somewhat flexible. If I am feeling aggressive about a trade, I may, in rare cases, take as little as 20 percent; if I am concerned about a trade, I will book 50 percent at the first profit target. Aggressiveness means something different to me than it does to many traders. I do not risk more on trades I really like—every trade within a trade class is a consistent percentage risk to the net liquidation value of the account ("net liq"). An aggressive approach to a trade simply removes *less* risk and books less profit at the first profit target.

In writing this chapter, my first idea was to use only trades that I had actually executed, whether published in my Waverly Advisors market report or in my own trading account. In the end, pedagogical concerns won, and I made the decision to include some patterns that I did not actually trade. The point of this chapter is to give you the best examples of patterns, to replicate a little bit of the decision process at the right side of the chart; there were patterns I did not trade at the time that serve this purpose better than those I did trade.

Most of these trade examples are presented with two separate charts, the first of which shows what would have been visible to a trader at the actual entry point. Spend some time looking at that chart and trying to understand the market structure and context for the setup. Next try to visualize the most probable price paths that could follow the patterns. Move on to the following chart, which shows the outcome of the trade and the pattern resolution. This second chart also has a heavy vertical line at the point where the previous chart ended to help put the resolution in the context of the setup. It is remarkable how seeing further price action can completely change your perspective on a pattern at the right edge of the original chart. It may be constructive to spend some time going back and forth between the setup chart and the result chart, as well as thinking about alternate ways in which the pattern could have resolved. These are a handful of isolated examples, but they have been carefully chosen and provide a good foundation for learning these patterns.

This chapter is a departure from the existing trading literature because of its emphasis on pattern failures. Trading patterns that work is easy: find a bullish setup, buy, take profits, and move on. However, pattern failures are common, and too many traders have tunnel vision, envisioning only the price movements they expect. When something unexpected happens, they freeze and large losses can result. Understanding the failures and breakdowns of patterns is an essential part of building intuition about the dynamics

supporting these trades. In your own work, focus more attention on the unexpected, on failed patterns, than on neat, perfect examples of successful trades.

Last, the discussions of these examples are, for the most part, kept to the most important and most obvious elements of the trade. In reality, any one of these trades could be the subject of deep investigation and could support a narrative running to hundreds of pages. If you think you see another way to understand or to read the patterns in some of these trades, you are almost certainly right. There is little discussion of other patterns and supporting factors (though the MACD and Keltner channels are reproduced on these charts, the text rarely discusses the patterns on these indicators). The trade-off was to provide you with many examples of relevant patterns and trade decisions.

TREND CONTINUATION

Trend continuation plays offer some of the best and most consistent trading patterns. Many traders find that these are their bread-and-butter plays, and that they are the backbone of a comprehensive trading program. All traders and analysts should be very familiar with the ways in which continuation patterns unfold, as a good grasp of these patterns leads to deeper insight into the strength and integrity of the trend.

Simple Pullback, Breakout Entry

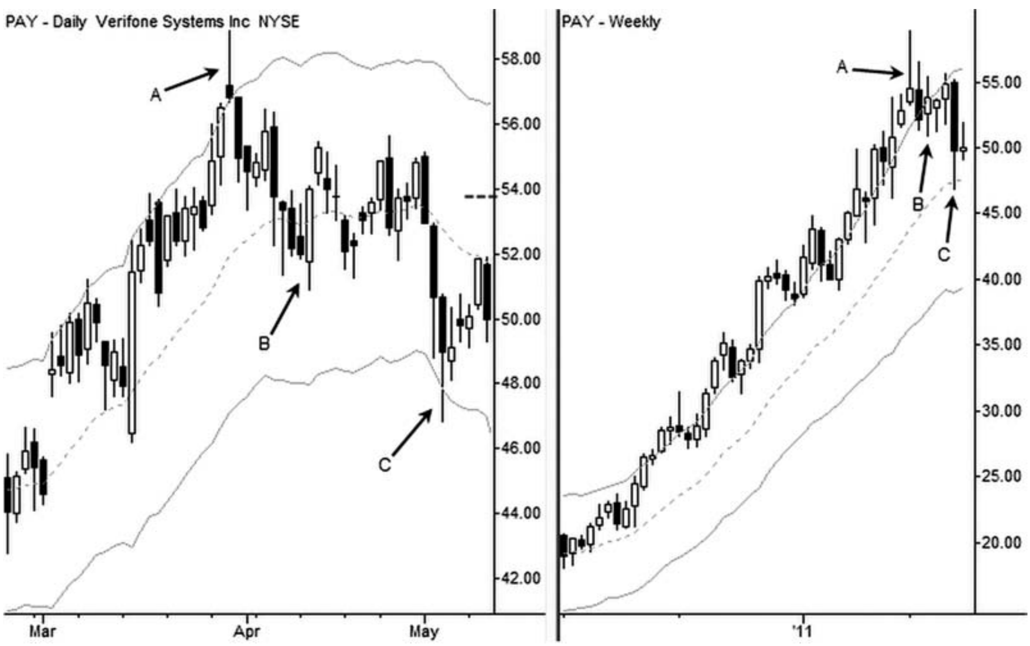

FIGURE 10.1 Short Entry in Verifone Systems Inc. (NYSE: PAY)

Setup

A: In Figure 10.1, a small climax on the daily time frame (left pane) caps a multiyear uptrend. Note that the weekly chart (right pane) is extremely overextended, with many bars pressing above the upper band and two free bars preceding A. This buying climax on the weekly chart provides the context for a potential short on the daily.

B: The daily chart shows a clear, two-legged complex pullback into B, followed by a failed attempt to resume the uptrend. Any trader contemplating buying this market at B should have been concerned that the weekly chart was still dramatically overextended at this point. An aggressive trader could have attempted a long entry at the bottom of this complex pullback, but should have been quick to reduce risk or exit the trade when the upswing failed a few bars after B.

C: A strong downswing brings the daily chart to the lower Keltner channel; the three days preceding C were a distinct change of character from recent price action. Note that the weekly chart has just now completed a complex pullback and has come into its (20-period exponential) moving average.

Entry The actual entry was on the last bar of the daily chart, ideally when it broke under the low of the previous bar. This is a case in which information about the intraday chart can be inferred from the daily time frame. The penultimate bar on the chart was a small buying climax on the intraday chart (not visible in this example). The reversal the next day, our entry, reversed this buying climax and took out a number of support levels intraday. Also, this entry follows a small two-legged complex consolidation that would have been more clearly visible on an intraday time frame, but is also clear on the daily chart—the small full candle two bars following C represents a failed attempt to continue the downtrend, and the second leg of the pullback exhausts itself into that intraday buying climax.

Stop An initial stop was established just under 54.00 (the small dotted line), with the plan to quickly adjust or exit the trade if there is no follow-through. A break like this should see immediate and sharp continuation.

FIGURE 10.2 A Successful Short Trade

D: The next day (see Figure 10.2), a news item hit this stock intraday, driving it well through the 1× (one times the initial risk) profit target and within striking distance of the second. In an active stock like this, traders may use intraday patterns to manage risk and to time entries, but must guard against executing in the insignificant noise of those time frames.

E: An attempt to drive through the lows fails (note the failure test at E), and most swing traders would have been taken out of this trade a few bars after E, against a greatly tightened stop.

F: There was a possible second short entry after another larger complex consolidation, but this trade is slightly out of the scope of the swing trader seeking the simplest, cleanest possible trades.

Conclusions This example illustrates what appears to be a simple, bear flag style pullback, but the context of the bigger-picture reversal from a parabolic higher time frame uptrend adds confidence to the trade. Furthermore, though there were opportunities for reentry and for longer holding periods, the swing trader's job is to be positioned for the single swing, taking partial profits around D, and most likely exiting the remainder completely on the failure test at E. This is a clean and simple trade, both in concept and in execution.

Simple Pullback, Breakout Entry

FIGURE 10.3 A Simple Pullback Entry in Zagg, Inc. (Nasdaq: ZAGG)

Setup Zagg, Inc. had been a market-leading stock for many months. Several previous examples of near-perfect pullback entries are marked on the chart (Figure 10.3), the second of which was a complex pullback. The current entry, at the right edge of the chart, has three warning signs: it is a divergence after at least the fifth leg in an uptrend, there is a momentum divergence on the MACD, and the stock is slightly overextended in a potential buying climax. In a very strong relative strength leader, it is permissible to take a trade with these conditions, which, in a more normal market, might be justification for passing on the trade.

Entry The actual entry was on the close of the bar that broke above the previous day's high. There were other structures visible on lower time frames, but volatility was compressed, as evidenced by the smaller ranges on the preceding bars, and it was enough to take a simple breakout exit on close.

Stop The initial stop was set somewhere around 11.25 (the small dotted line). It may seem like the stop could have been higher, for the pullback pattern would be decisively violated just below the recent lows, around 11.75. However, the placement of this stop

was a risk management decision. Placing the stop farther away from the market results in a smaller position size; this is a prudent step in a potentially overextended market that could reverse on high volatility.

FIGURE 10.4 A Successful Pullback Trade

Overnight news drove the market to open around the first profit target (Figure 10.4). Many traders would have been tempted to not take partial profits here, or even to add to their positions, with the idea that the news could drive the stock into a new, steeper uptrend. While this is always possible, it is not what *usually* happens. Usually, large gaps like this lead to increased volatility; selling some of the position at the first target will mean that even though the stock may fluctuate wildly, your P&L will not.

A: After one very strong session, the stock began a pullback or a decline that ended in the volatile session marked A. Remember this pattern: A session with a long shadow in the direction of the preceding swing is often a small climax. In this case, a selling climax was clearly visible on intraday charts.

B: Though not the focus of this example, another long position could have been initiated on a breakout of the small days following the selling climax. Consider the bigger picture: this stock was driven higher on news, began a multiweek pullback that ended in a selling climax, and then spent two sessions in volatility compression. At this point, the stock was potentially primed for a directional

move, and another long position was justified. Last, note that this leg ran into some resistance just under 16.00, which was approximately the high of the June spike.

Pullback, Lower Time Frame Climax Entry

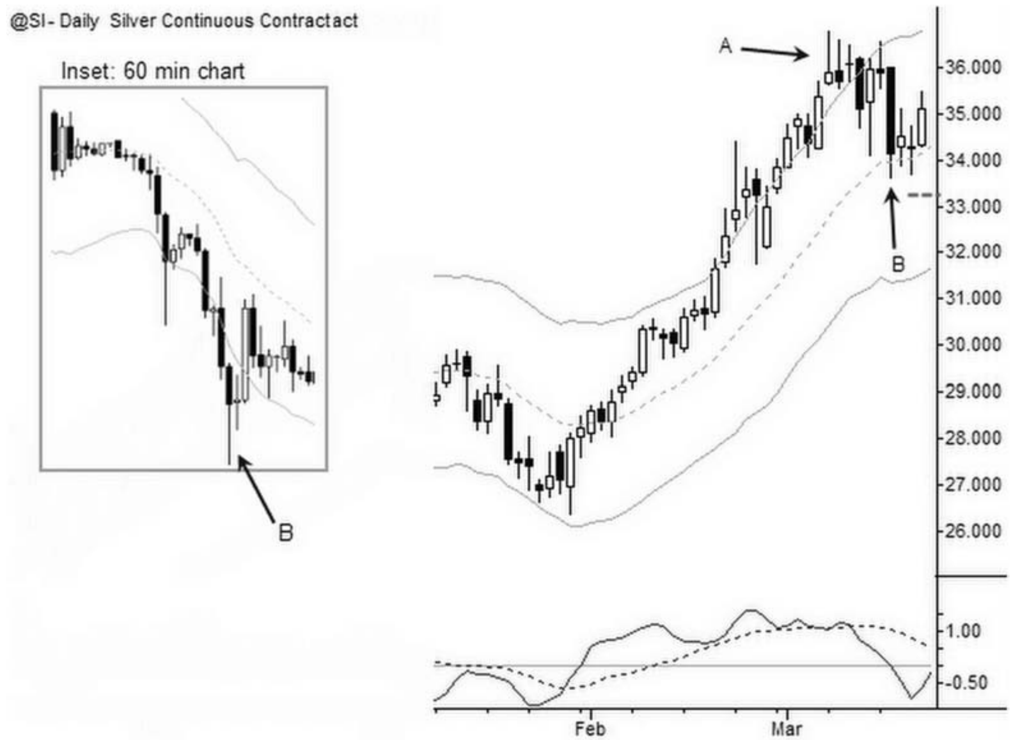

FIGURE 10.5 Lower Time Frame Climax Sets Up a Pullback Entry in Silver Futures

Setup Different markets have different tendencies to trend, and it is important to adjust your trade expectations based on these tendencies. Though it is a gross overgeneralization, currencies tend to trend longest and best, commodities are somewhere in the middle, and equities are more prone to mean reversion and reversal than long trends. Silver had just come from an impressive two-and-a-half-year trend, but this small climax and reversal (see Figure 10.5) were unlikely to be enough to end the trend.

A: Again, note the buying climax evidenced by the free bars above the channel. There is *no* momentum divergence here, as there are no swings, only a steady grind up to A.

B: The rule is to not buy pullbacks following a buying climax, and the bar preceding B is exactly why: fake-outs and false entries are normal in these environments.

However, notice what happens at B and the inset chart, which shows an intraday perspective on B and the bar before: a strong selling climax on the 60-minute time frame brings the market to the bottom of the daily consolidation.

Entry This selling climax is most likely evidence that many weak-hand longs have been flushed out, and it sets up a potential long entry. After this much work, meaning time spent consolidating, the buying climax is effectively worked off. After two bars' consolidation (volatility compression again), the small breakout on the last bar of the chart is a reasonable spot to initiate a long trade.

Stop A stop was established not far underneath the consolidation. If the trade is going to work well, the lower time frame selling climax should mark the bottom for the foreseeable future. There is no point giving a trade like this additional room to move against you after the entry, so a tight stop is justified.

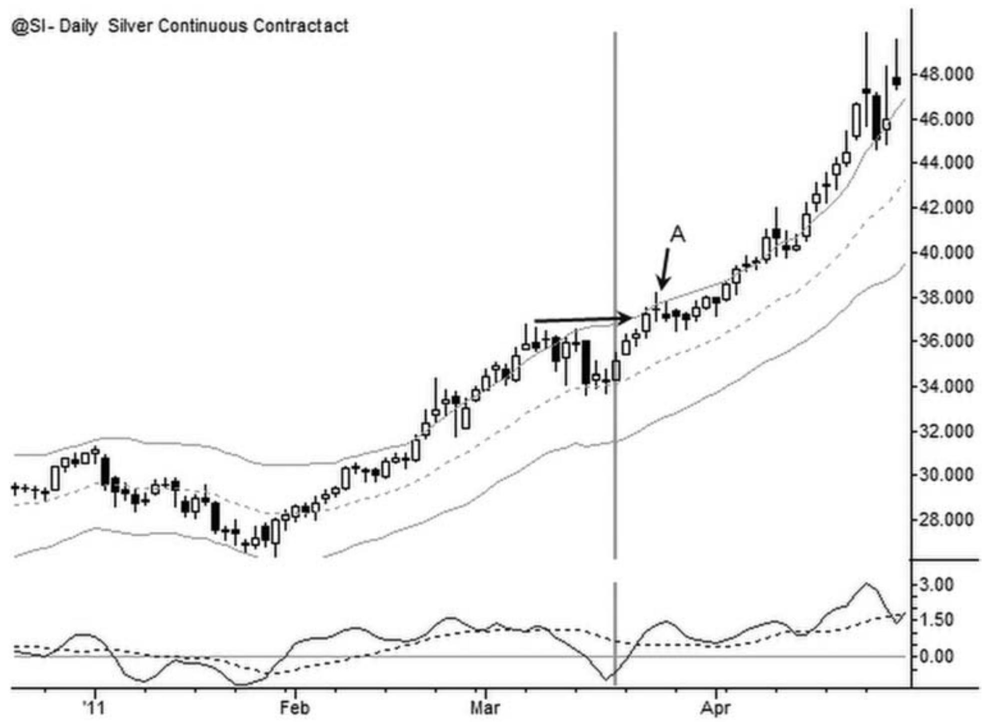

FIGURE 10.6 A Pullback Entry Leads to a Multileg Trend

There was no pain on this trade. Silver traded smartly higher, running into some resistance at A in Figure 10.6, just beyond the first profit target for this trade. Consider how a trading plan like this puts you in control. If you entered after the flush, took partial profits at 1× your risk or the previous swing high, and now hold a partial position against a raised stop, the worst possible outcome is a small profit. (Be careful with phrases like

"worst possible outcome" though, because there is always the possibility of an outlier. But for all practical intents and purposes, this would be a risk-free trade at this point.)

Conclusions The outcome of this trade is an example of the best-case scenario in which the market accelerates into further trend legs. At the time of entry, the trend was already potentially overextended, but there were other factors that suggested the possibility of a continued advance. Buying blindly into such an overextended market is dangerous, as sudden, sharp reversals are to be expected, but a good technical pattern can provide a clear risk point.

The discipline of taking partial profits is important: pay yourself as the market makes profits available, and, in doing so, reduce open risk in the trade. Many traders looking at a chart like this try to find ways to pile in and maximize profits, but they will often find themselves with top-heavy positions at the points where volatility explodes. By reducing risk as the trade matures, the position will be able to endure elevated volatility without excessive swings or unnecessary risk.

Pullback, High and Tight

FIGURE 10.7 A High and Tight Flag in AMZN

Setup Casual inspection of a chart can sometimes give insight into the character of a market. In this case (Figure 10.7), Amazon.com, Inc. (Nasdaq: AMZN) appears to be a volatile and somewhat unpredictable stock—sharp reversals and gap openings are the norm. You have essentially two choices trading a market like this: either use very large stops and small position sizes or limit your involvement to the points where you have the clearest possible patterns. The high and tight flag at the end of this chart is such a setup. Look at this chart and consider what you will do the next day if the stock trades above the previous day's high. Though most traders will see that the breakout of the high of the last bar is a good entry, consider what you will do if the open gaps above that high. These patterns often build up a lot of pressure, and it is not uncommon to see opening gaps beyond the confines of the pattern. These can be difficult entries because you may find yourself executing at adverse prices, but these gaps often point to a powerful shift in the underlying dynamics.

Mark this example well. Two days before the end of the chart, the stock had one of its strongest up closes in recent history. At this point, it was potentially overextended (especially on lower time frames), but two days of tight consolidation worked off that condition and set up the potential for a good directional move. The fact that a market *can* consolidate near the highs of a large thrust (meaning that mean reversion has failed in this case) is strong evidence of underlying buying pressure.

Entry There are several ways to actually enter a pattern like this. The easiest is simply to pay a breakout (or a breakdown, for a bearish consolidation) of the small pattern. Expect volatility expansion. If the trade is going to work well, it should work quickly; be suspicious of markets that go dull and flat following an entry like this.

Stop You could make the argument for a tighter stop than the one indicated on the chart, which is just under 190. Would you really hold it to that point if the next day took out the last day's high, triggering a long trade, and then the stock turned and melted down? Few traders would, but again, the widened stop is a risk management decision. The proper stop for the pattern is much higher, probably around 191.50, but the wider stop, in this case, was seen to be a more prudent use of capital and risk given the prevailing volatility conditions and the risk of a large opening gap.

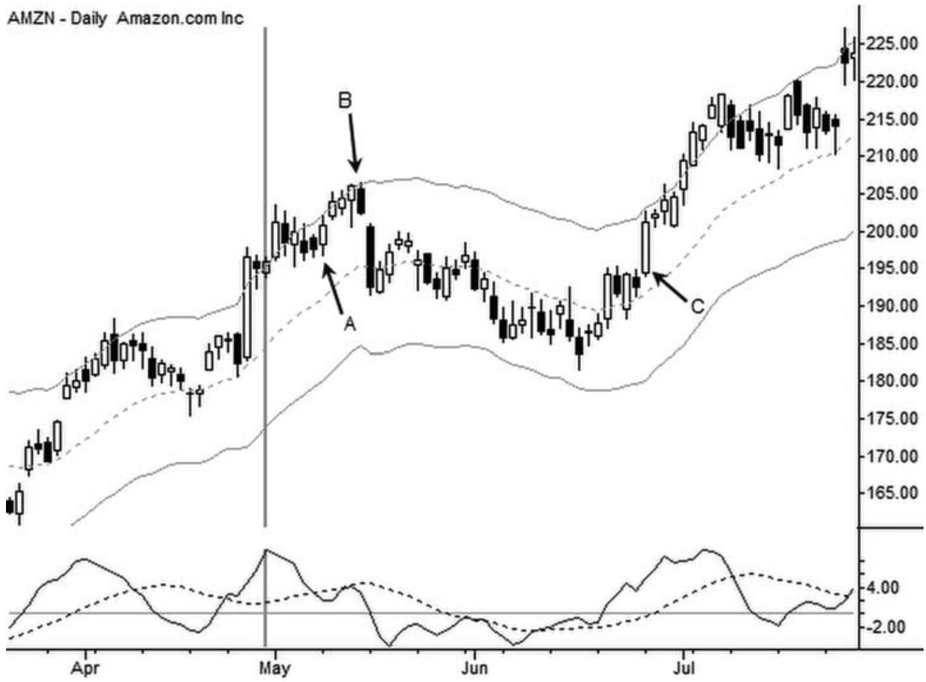

FIGURE 10.8 Targets Are Hit, but the Move Is Weak

If you had entered on the next open (see Figure 10.8), which gapped above the consolidation pattern, the first target would have been touched within the same session. Once again, reducing risk at this target is a key to effective position management.

A: The initial thrust out of the pattern did fail by going into another consolidation pattern. Depending on risk tolerance and the willingness to hold a flat position, a trader could have been justified in holding through this pattern, but it is not an example of best practice.

B: Another thrust to highs fails to see follow-through, and generates a glaring sell divergence on the MACD. Where should you exit any remaining long exposure? Though B is a downward close, it is a small range day and is still potentially consistent with consolidation. However, the next open gapped lower and traded down off the open with a vengeance. Any remaining longs should have been out long before the close of this day.

C: Another possible long entry, but not an example of one of the best setups on this time frame. A trade entered at this point would essentially have been a trade on the weekly time frame, as the long consolidation was required to work off the meltdown from B, following three pushes to a high. Appropriate stops for a trade entered at C are far away, perhaps under 175. Again, this large stop is consistent with a trade executed on the weekly time frame, but is far too large for the daily chart.

Conclusions This is an excellent example of a high and tight flag. If a market makes a strong thrust in either direction (one to three bars) and is able to consolidate near the extreme of that thrust for a few bars, this sets up a good continuation play on a breakout of the pattern. This is potentially an aggressive trade that can lead to volatile swings both for and against the position, and it does require active management. This particular example had an anticlimactic outcome, though the setup and entry were textbook examples of the pattern.

Pullback, Nested

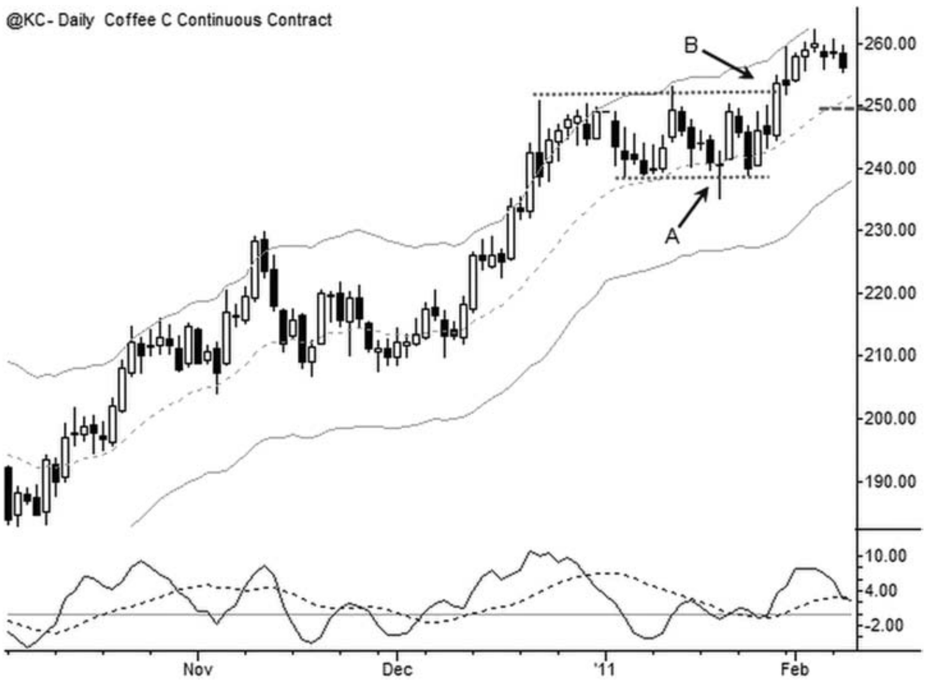

FIGURE 10.9 A Nested Pullback in Coffee Futures

A nested pullback is a small consolidation pattern that sets up in a drive from a larger, possibly higher time frame pattern. In some sense, it is simply a pullback preceded by the typical strong setup thrust, but the difference is that bigger-picture context and motivation are provided by the larger pattern. This particular example (Figure 10.9) is a breakout from a multiweek range that showed no signs of failure or reversal, so the first pause was a reasonable spot to increase long exposure. Note that there is some overlap between these setups, and this could just as well have been categorized as the first pullback following a breakout.

A: Though it was not clear at the time, A marks a classic Wyckoff spring. It is not always necessary to trade these patterns; much of the benefit comes from the

information they add to the market structure. In this case, the presence of the spring pointed to accumulation in the range and suggested that the breakout might have some real strength behind it.

B: The actual breakout happened over several sessions and showed no signs of exhaustion or failure. At the end of this chart, the market was consolidating in a tight pullback.

Entry This is another type of very small pullback, and the same entry techniques that work for nested pullbacks will serve here. Look at the last bar on this chart and ask yourself: is there a potential entry on strength on the next bar?

Stop Some traders may prefer to use a very tight stop on a pattern like this, and it certainly is possible. My choice to use a slightly deeper stop is primarily a risk management choice that respects the tendency for volatility expansion following a contraction like this. There is also no rule that says you must hold a position to the stop level; in many cases, it makes sense to exit the trade once the pattern is decisively violated.

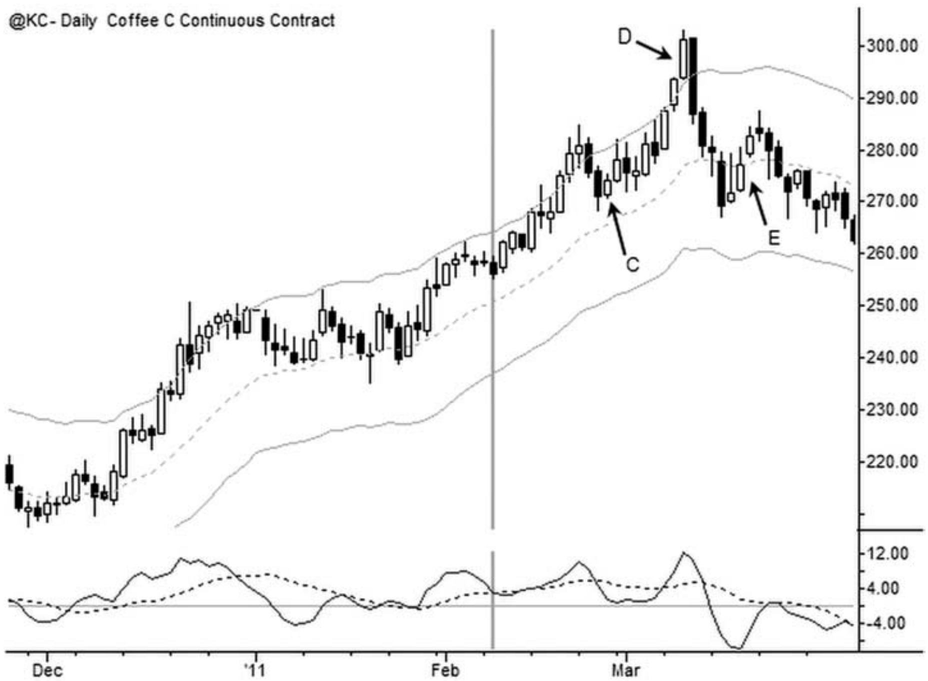

FIGURE 10.10 Two Strong Trend Legs Follow the Nested Pullback

Coffee broke out of the small nested pullback, and accelerated into an even stronger trend leg, as evidenced by the thrust above the upper Keltner channel in Figure 10.10.

C: This is an example of how a technical pattern may be used to manage an existing position, even if it is not strong enough to justify a stand-alone entry. It would

have been difficult to initiate a trade on the small pullback at C, but traders holding existing longs could see that the pattern was unfolding according to expectations.

D: This is a classic example of a minor buying climax. Note the parabolic acceleration, the free bar, and the immediate sharp reversal. This is precisely the kind of pullback you *do not* want to buy, so existing longs should have exited their positions somewhere in this move. You will never sell the high tick of the move (D), but you will be able to limit losses on the reversals. This area also brings up the limitations of an indicator; the MACD did not show a momentum divergence, but the price structure was clearly climactic.

E: The downthrust at D was strong enough to set up a potential short (an Anti trade) in the pullback at E. At the very least, being caught long on a breakdown of this pattern is unacceptable.

Conclusions There are many things going on in this example. Most important is the idea of using a small consolidation as an entry trigger into a bigger pattern. The successive price action at C, D, and E is also a good lesson in using these patterns to manage existing positions.

Complex Pullback

FIGURE 10.11 A Complex Pullback in the EURUSD

Setup

A: After a month-long drive coming off a failure test of the lows in early January 2011 (see Figure 10.11), the EURUSD showed some signs of exhaustion near the upper band and rolled over into a pullback.

B: It would have been a reasonable play to attempt to establish a long position following this pullback, but most long traders would have had a losing or, at best, breakeven trade following B.

Entry After such a losing trade, many traders are tempted to move on and to remove the market from consideration. This is a mistake. A much better plan is to continue to monitor developing market structure, understanding that a complex pullback is likely. There are several possible entry techniques, ranging from buying tests of the pattern based on trend lines (not relevant in this example) to again paying small breakouts near the bottom of the pattern.

Stop It is reasonable to establish tighter stops on these complex consolidations than on simple pullbacks. Moves out of these patterns should be both cleaner and stronger than corresponding moves out of simple pullbacks; a failure out of a complex consolidation is much more likely to lead to a sharp reversal and complete failure of the pattern, so further stops tend to result in larger losses with no compensating factors of probability or reward/risk.

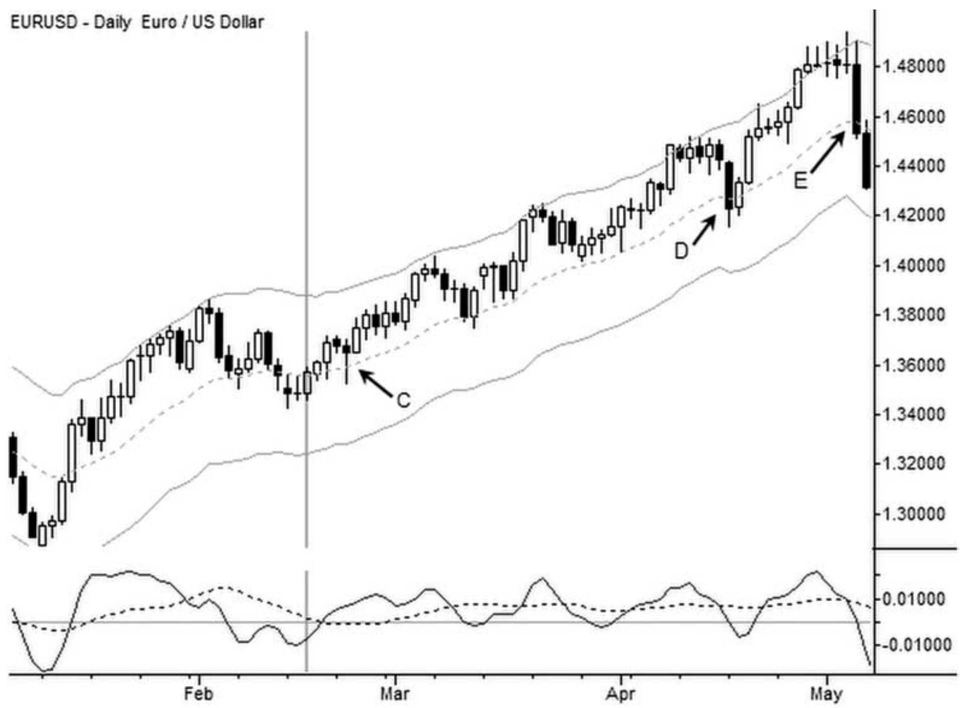

FIGURE 10.12 A Complex Consolidation Leads to Significant Upside

If you executed the trade with this stop, there are several choices for targets. I set my first target at one times my risk in almost all cases, the only exceptions being when that target would be beyond a very visible chart point. In this case (Figure 10.12), there was additional volatility at C, but you should have already sold a portion of your exposure at the first target. Once again, booking partial profits and reducing open risk puts you in a position of strength and you can watch action at C and not be forced to react.

It is also worth noting that the long lower shadow on the candle at C suggests a lower time frame selling climax. Though it is an extremely aggressive entry, and not appropriate for most traders, adding or entering long positions over the high of C is a possibility to consider. (This is a variation of the nested pullback idea.)

D and E were both large drops against the uptrend, and should have been warnings that the trend was vulnerable. After a strong sell-off like E, it is difficult to justify holding long positions in the time frame relevant to this chart.

Conclusions Again, much more data has been shown than was needed. Most swing traders, playing for only one clean swing, would have been out of their positions before D. Two other points to consider here: currencies do not tend to trade as cleanly as most other markets, so many technical traders will find better results trading them on higher time frames. Last, a complex pullback is usually a higher time frame simple pullback. This is why the moves following these patterns tend to be stronger—they are more correctly higher time frame drives.

Complex Pullback

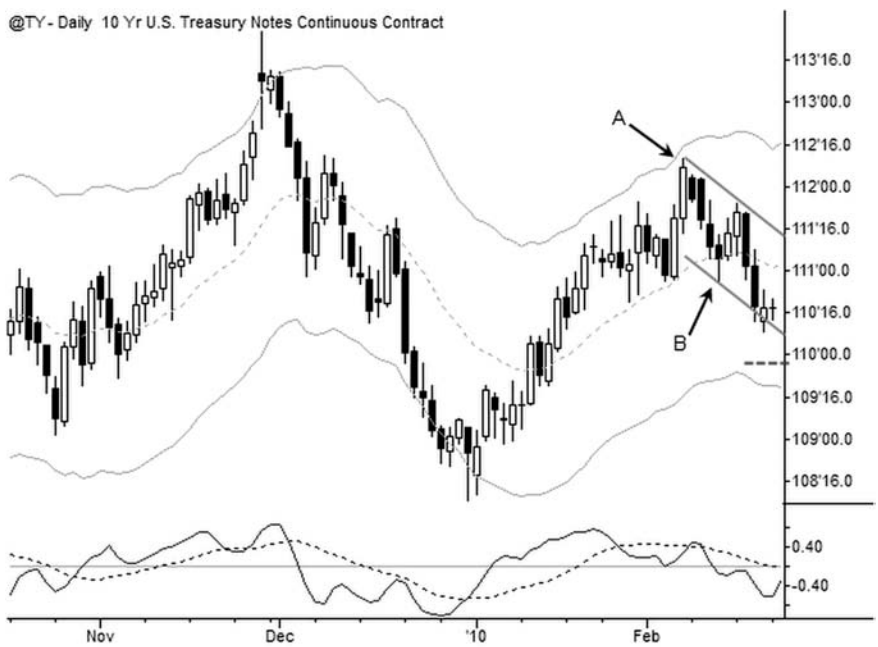

FIGURE 10.13 A Complex Pullback in Treasury Note Futures

Setup

A: After a small exhaustion on lower time frames, Treasury futures began a five-day pullback.

B: Once again, a long entry was reasonable at the bottom of the first pullback, but would have resulted in a losing or, at best, breakeven trade when the first pullback failed.

Entry Another leg down brought the market to a potential entry for a complex pullback. Though only one time frame is shown in Figure 10.13, it is not difficult to visualize the higher time frame: The long drive off the January lows would be a single thrust on a higher time frame, and the complex pullback on the daily chart would resolve in a simple pullback on the higher time frame. You want to avoid buying into the middle of a pullback like this. Focus attention on establishing positions either on breakouts, *with* the anticipated momentum, or near potential support in the pattern.

This trade shows a hybrid entry technique. The last downswing pressed the pullback below the parallel trend line, parallel to the standard trend line drawn across the top of the pattern. This highlights a very small selling climax, and sets up a potential long entry on strength in the next trading session.

Stop Again, stops can be tighter in complex pullbacks than in standard pullbacks. A reasonable stop is just under 110'0, and certainly no deeper than 109'12. There is no point in holding a complex pullback through another countertrend swing. These structures do exist, and they sometimes offer continuation in the direction of the trend, but they are not great trading patterns.

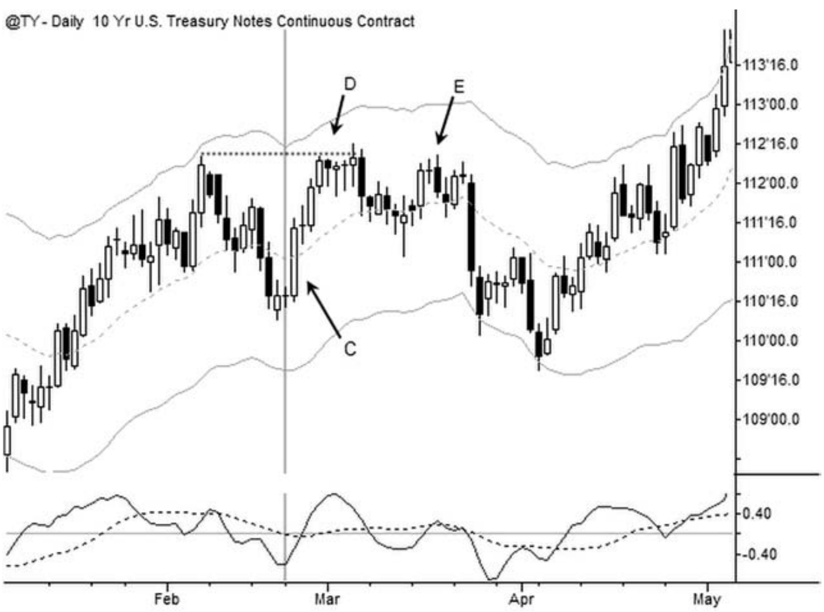

FIGURE 10.14 Is This a Failed or Successful Pullback Trade?

This example highlights the importance of trade location. Consider the entry bar C in Figure 10.14. If the actual entry was made on the close of that bar, the risk point may have been far enough away that no profit targets were hit before the move stopped near D. However, if the entry was done closer to the breakout of the previous day's high, first targets (at 1× risk) would have been reached on the second or third bar following C.

The consolidation at D is cause for concern for longs, but not necessarily justification for exiting the full position.

Pullback Failure at Previous Swing

FIGURE 10.15 A Pullback Failure at Previous Swing

The first common pullback failure is a failure near the previous swing that set up the pullback. Is this actually a failure? The answer depends on your expectations for the pattern. It is a failure if you were expecting another complete trend leg or legs to emerge, but the conservative target for a pullback *is* that previous swing point. Furthermore, if you have been able to establish a position near the bottom of a pullback in an uptrend or near the top of a pullback in a downtrend, the first 1× risk target may already have been hit. If this is a failure pattern, it is a failure that can often result in a profitable trade. The most common error here is to not recognize the failure, to continue to hold the trade, and to take a senseless loss on the position.

A: In Figure 10.15, this day provided an ideal entry into the small pullback, showing a small selling climax and subsequent failure on the part of sellers.

B: The swing falls short of the previous high. Consider the character of the move we expect to see out of ideal pullbacks: the best examples will show strong conviction, which this clearly does not. It would have been difficult to hold longs through the session following B.

C: No swing trader should still be long, but here is an actual failure test entry for shorts. If, by some chance, you are still holding a long position against a signal like this, exit immediately.

Pullback Failure at Previous Swing

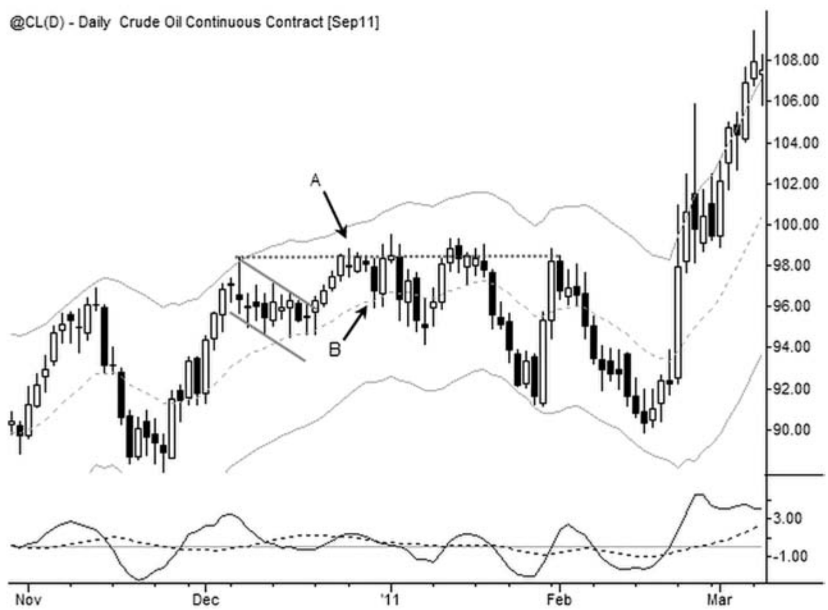

FIGURE 10.16 A Pullback Failure in Crude Oil

A: The same theme is in play here in Figure 10.16, except the pullback setting up the failure was not as deep, so first profit targets may not have been hit (depending on stop placement). Once again, the consolidation just under resistance at A is potentially constructive. Ideally, we would like to see more conviction and an easier break of resistance, but everything at this point is still supportive of the long trade.

B: There are several logical choices for managing a trade like this:

- Take partial profits at A, when the market runs into resistance, even though the 1× target has not been reached.
- Tighten stop under A, so that part or all of the position is exited on the bar marked B.
- Move stop to breakeven at A so that the worst intended outcome is a scratch. Remember that gap risk exists; the actual loss may be larger.

Whichever plan makes sense to you, the important thing is to execute it consistently. By B, it was clear that the pullback trade was not working cleanly and steps should have been taken to adjust or exit the trade. Also, remember the job of a swing trader is to take money out of one clean swing in the market. No swing trader, working on this time frame, would have been justified holding the trade through the multiple tests and failures of the resistance level, even though the market did eventually trade higher. Focus on finding and trading only the best and clearest opportunities.

Pullback Failure: Strong Momentum Develops

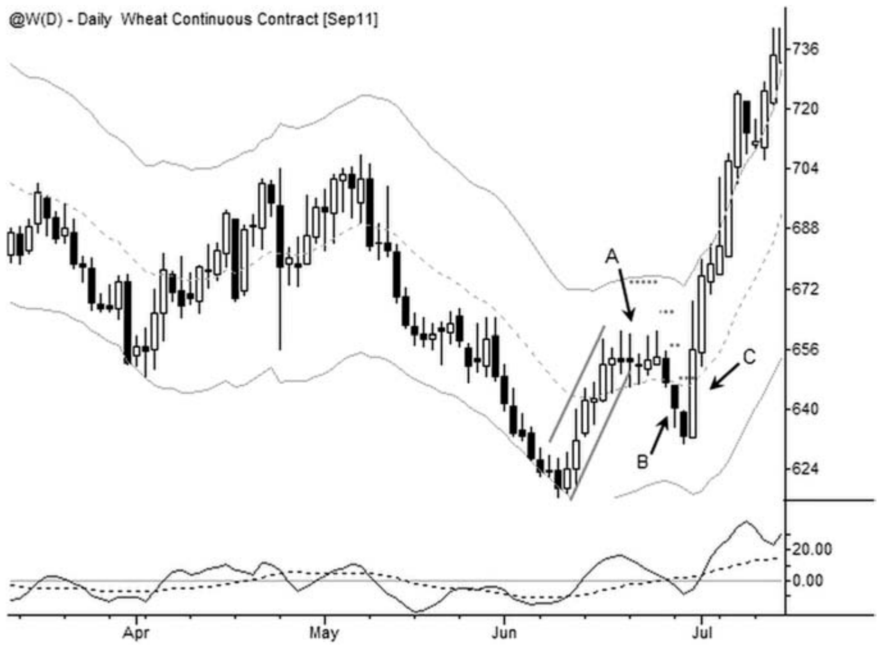

FIGURE 10.17 A Bearish Pullback in Wheat Fails When Strong Upside Momentum Emerges

Figure 10.17 shows a consolidation pattern in a downtrend. There were several spots to enter a short position:

A: The small bars in this area are evidence of volatility compression and justification to take trades in the direction of downside breakouts from this area. There were several spots to enter a short position somewhere around A, against a stop somewhere around the highest of the small dotted lines.

B: At this point, the second downward closing bar, the trade is working. This is a small, but very important point: once a trade is working, once the market is moving in the intended direction, tighten stops to reduce open risk. This is not a precise trailing stop methodology, but remember that once the trade begins to

work, if it turns back up, a complex consolidation is a likely outcome. There is no point in booking a full-sized loss on a transition into a complex consolidation, and then possibly not having the capital or the will to attempt another trade in that pattern.

C: In this case, extremely strong upside momentum developed against the pullback. Though it was still possible that the pattern would develop into a complex consolidation, after momentum this strong it probably makes sense to move on to better opportunities—this is not what you, as a short or a potential short, want to see. Note that even though this appears to be a catastrophic pattern failure, the actual loss on the trade should have been very small against the lowered trailing stop.

This is a common pullback failure pattern, and a good reminder of the importance of moving stops. Trade management does not necessarily mean executing—everyone understands the idea of reducing position sizes to limit risk, but sometimes simply moving a stop is the right answer. Remember, your job as a swing trader is to take money out of the cleanest single-leg moves in the market. Never let a trade that is working turn into a full-sized loss.

Pullback Failure: Goes Flat After Entry

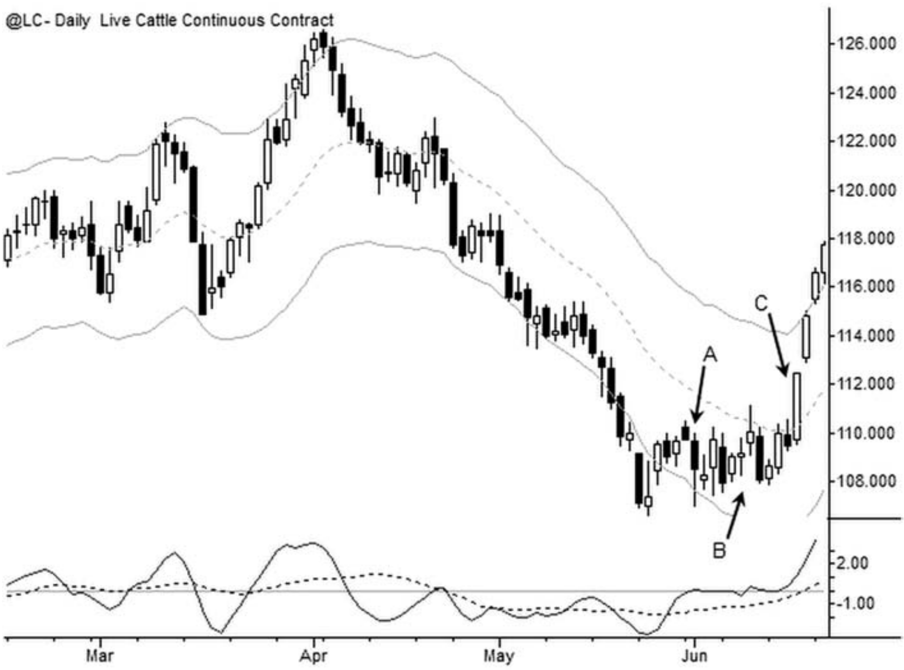

FIGURE 10.18 A Pullback in Live Cattle Futures Goes Flat

Every edge we have as technical traders comes from an imbalance of buying and selling pressure in the market. We get into pullback trades, such as the one in Figure 10.18, under the assumption that the pressure driving the trend will continue after the pause that creates the pullback. If this assumption is incorrect, the market may simply go flat after the trade is entered, without a significant move up or down. This is strong evidence that the market has temporarily found equilibrium and that whatever edge there might have been in the trade is now gone.

A: This bar offers an excellent entry into a pullback in a strong downtrend. After a strong down bar, the market consolidated with an inside day (a day which has a lower high and higher low than the previous day); this type of consolidation is perfectly consistent with the downtrend, but the next day broke to the upside. You have to decide how reactive you wish to be to small signals like this. In general, there is too much noise in most markets to trade every small movement, but at this point it is reasonable to say that this is not an example of the cleanest possible trade.

B: Even if you are prepared to trade pullbacks with a lot of patience, this is too long to sit in a simple pullback. The market is flat; the anticipated breakdown did not happen, so it makes sense to scratch the trade, exiting for either a small win or loss. Note also that B is a potential sign of distribution, a Wyckoff upthrust. Be careful of seizing on elements like this to justify overstaying your welcome in trades that are not working. This was a simple pullback trade that should have broken down long ago. Get flat.

C: In this case, the break was to the upside, but the point is that it was a coin flip—there was no point being in the trade by this time; your capital, both financial and mental, would be more profitably deployed elsewhere.

TREND TERMINATION

Trend termination plays are slightly more complex than trend continuation plays. There is more potential for extreme volatility and large surprise moves near the end of trends, so it may make sense to trade some of these on smaller size and portfolio risk. In addition, outcomes are not as clearly defined—there are many instances where the trend does terminate, but there is not enough play or price movement to give substantial profits. In all cases, the discipline of taking partial profits and managing risk on the remainder of the trade are essential skills for these types of trades.

Failure Test

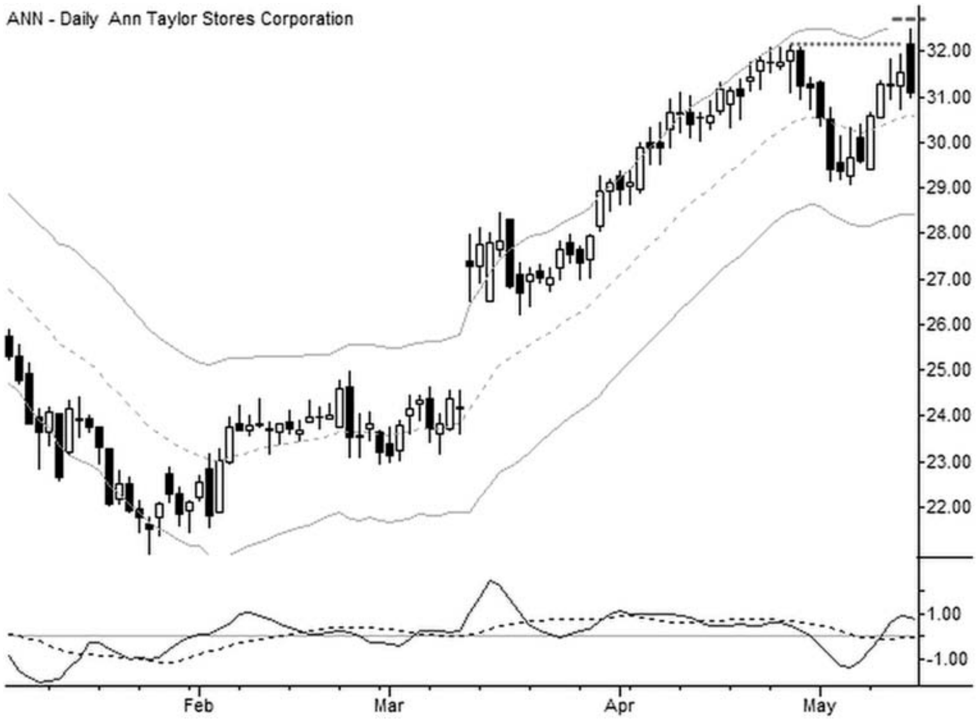

FIGURE 10.19 A Failure Test in Ann Taylor (NYSE: ANN)

Setup ANN had been in a multimonth uptrend, and was, in fact, a market leader for a substantial part of the advance shown in Figure 10.19. In general, it is difficult to find spots to short market leaders, so only the best and clearest trades are appropriate. A strong sell-off going into May broke the established pattern of the trend, putting with-trend traders on notice and giving countertrend traders warning to start watching for potential entries. This is an important and often overlooked aspect of countertrend trades: you must have some reason, some justification for even considering a countertrend trade, and the best justification is price action that shows a distinct change of character.

Entry The actual entry was on the day that pressed to a new high and immediately reversed, closing strongly lower. There is a trade-off between trade location and confirmation here. While an astute intraday trader may have been able to position somewhere near the high of the day, a trader doing so as a matter of course will unavoidably have many losing trades that reverse and take out the highs. A trader waiting for the close will give up significant price movement in return for the confirmation. Either plan will work if it is applied with discipline.

Stop The stop in this trade should be located at or around (within a few pennies of) the previous trend high. Many traders will place the stop *outside* the previous trend extreme, but this can result in considerable slippage. Placing the stop inside the previous extreme will result in a rare stop-out where the trade is still valid, but the reduced slippage on nearly all exits will more than compensate.

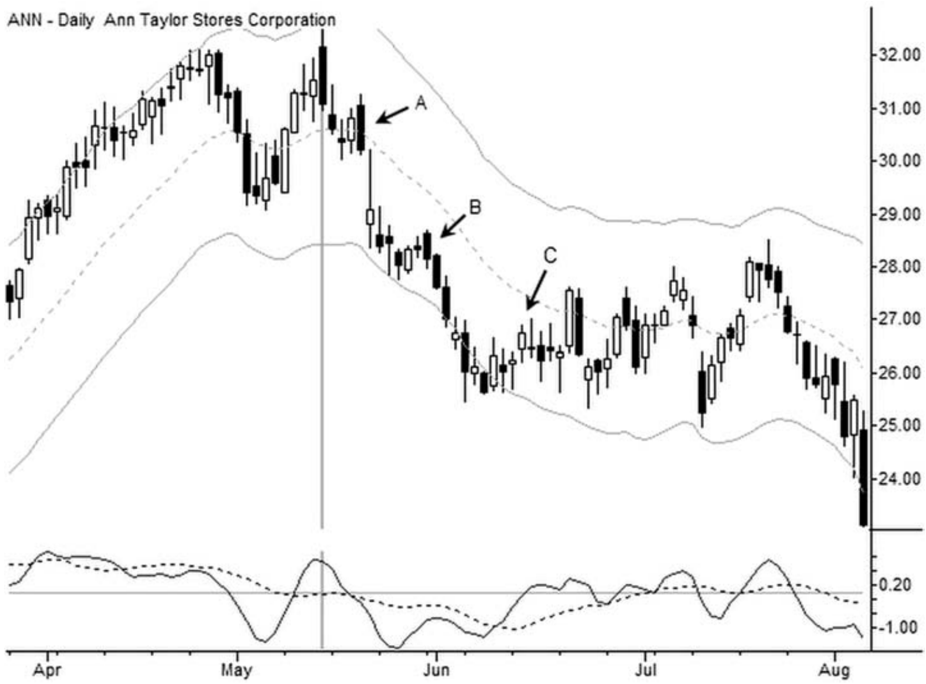

FIGURE 10.20 A Best-Case Failure Test Outcome

The chart in Figure 10.20 is an example of practically the best possible outcome from a trade like this. First (1×) profit targets would have been hit early on, and in this case, the failure test actually marked the extreme high point of the trend.

A: After a strong downthrust, a small consolidation like this often points to more downside—you can enter new positions here, add to existing positions, or just use the pattern as a reference to manage existing exposure.

B: Even if you do not choose to trade pullbacks, they are the fundamental structure of trends, and being able to read price action around pullbacks will give you great insight into the integrity of the trend. Many traders would have covered much of their trade by this point, but seeing small consolidations break down cleanly could give you justification for holding part of the trade.

C: Continuing with that theme, when you see these patterns *not* break down as cleanly or easily, it is a sign that something has shifted and the easy money in the trade is probably over.